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No. 1070

In the Supreme Court of the United States

OCTOBER TERM, 1944

TALBOT MILLS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court (R. 73–81) is reported in 3 T. C. 95. The opinion of the Circuit Court of Appeals (R. 93–104) is reported in 146 F. 2d 809.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 22, 1944 (R. 104). The petition for a writ of certiorari was filed on March 22, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

For 80 percent of its outstanding stock, taxpayer, a family corporation, substituted notes providing for maturity in 1964, interest at a variable rate of from two percent to ten percent contingent upon annual net earnings, deferment of interest in the discretion of the directors, subordination of both principal and interest to outside indebtedness, and other restrictions. The question is whether "interest" accrued by taxpayer for its fiscal year 1940 at the rate of ten percent, computed with reference to its net earnings for that year, was in reality a dividend and accordingly not deductible as interest on indebtedness within the meaning of Section 23 (b) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *
>
> * * * * *
>
> (26 U. S. C., Sec. 23.)
>
> SEC. 115. DISTRIBUTIONS BY CORPORATIONS.
>
> (a) *Definition of Dividend.*—The term "dividend" * * * means any distribu-

tion made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *.

* * * * *

(26 U. S. C. Sec. 115.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (b)-1. *Interest.* — Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *.

* * * * *

So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. * * *

STATEMENT

The facts as stipulated (R. 8–53) and found by the Tax Court (R. 74–78) may be summarized as follows:

Taxpayer, a Massachusetts corporation, keeps its books and files its returns on the accrual method, and on the basis of fiscal years ending September 30. Prior to the beginning of its fiscal year ending September 30, 1940 (the taxable year), it had outstanding 5,000 shares of $100 par-value common stock, or total capital stock of $500,000, and a surplus on its books of $472,-

754.18. The stock was held by 15 stockholders who, with the exception of one holder of 10 qualifying shares, were either members of the Talbot family or trusts created by them. (R. 9–10, 74.)

In 1937, after taxpayer had been operating for several years at a loss, there was some discussion among the stockholders regarding liquidation. On the basis of a proposed plant renovation and personnel reorganization, and also a possible recapitalization, they decided to continue the business. In May 1939, the treasurer was authorized "to retain counsel to examine the capital structure of the company with the view to seeing if any modification can be made in same to the advantage of the company." On September 14, 1939, a plan of reorganization was submitted to and adopted by the directors and on September 29, 1939, it was approved by the stockholders. (R. 11, 40–41, 74.) The plan called for surrender by each stockholder of four-fifths of his stock in exchange for "registered notes" of face amount equal to the par value of the stock surrendered, and pursuant thereto $400,000 of notes were issued to the stockholders in exchange for a like amount of stock (R. 11–12, 74).

The notes provide for maturity on December 1, 1964, and for interest at a variable annual rate dependent upon taxpayer's annual net earnings. The interest rate is to range from two percent to ten percent, the applicable rate for any fiscal year to

correspond to the percentage (to the nearest ¼ percent) which two-thirds of taxpayer's net earnings for the year bears to the principal amount of the notes. The interest so determined is payable on December 1 of each year, but payment of it may be deferred for any length of time (not beyond the maturity date of the notes) that the board of directors "may in good faith determine to be necessary by reason of the condition of the corporation." No dividends are to be paid on the remaining one-fifth of the stock until interest due on the notes is satisfied. (R. 19–20, 74–75.)

In the event of bankruptcy, receivership, dissolution or liquidation prior to December 1, 1964, the principal, together with interest accrued and unpaid, is to become immediately due, with interest at six percent from the close of the preceding fiscal year. However, the directors are authorized "to subordinate all of these notes as to both principal and interest to any other indebtedness of the corporation maturing not later than December 1, 1964," in which event any sums or other property payable on the notes are to be paid over to creditors to whose claims the notes have been subordinated. The corporation may at any time retire the notes at par plus accrued interest, unless otherwise provided in any subordination agreement. No mortgage to secure an obligation maturing after December 1, 1964, other than a purchase money mortgage, may be made without

the consent of holders of three-fifths in interest of the notes. (R. 21–22, 75–76.)

Any of the terms of the notes may be altered by the corporation with the consent of holders of three-fifths in interest; provided that no such change shall extend the maturity date for the principal or reduce the principal amount, alter the rate or method of computing the rate of interest, or affect any subordination agreement in force (R. 23–24, 76).

The notes are transferable by endorsement on an attached form. Only a few notes, totalling $6,800, have been transferred, all within the close family circle. (R. 24, 76.)

Tax avoidance was a motivating factor in the adoption of the plan (R. 74), and appears to have been the only substantial purpose underlying the exchange of notes for stock (R. 80).

Within two weeks after the adoption of the plan, and on October 10, 1939, the notes were subordinated by taxpayer's directors to two loans from one bank in the amounts of $50,000 and $30,000, respectively, bearing interest at four percent and three percent per annum, respectively; to a $50,000 loan from another bank, bearing interest at four percent per annum; and to a $100,000 loan from another creditor, bearing interest at six percent. The subordination agreement with the two banks covered all existing and future indebtedness and provided that so long as any part

of the bank indebtedness remained unsatisfied taxpayer would not pay and the noteholders would not accept any payment of principal or interest on the notes; that in case of taxpayer's bankruptcy or any other liquidation proceeding the noteholders would assign and pay over to the banks all distributions to which they might be entitled in such proceedings; and that in case of a reorganization or composition any payment to the noteholders would likewise be turned over to the banks. All these subordinations have since been terminated by payment of the senior obligations. (R. 14, 29–35, 76–78.)

Shortly after the close of the taxable year, and on November 27, 1940, taxpayer's treasurer reported that (R. 13, 78):

> * * * he had ascertained and fixed at 10 per cent the rate of interest applicable to the registered notes of this corporation for and on account of the fiscal year ended September 28, 1940, such rate of 10 per cent being a rate less than that computable with reference to the net earnings of said fiscal year under the terms of said notes and being the maximum rate provided by the terms of said notes.

This report was forthwith accepted and approved. The directors then voted to defer payment of three-fourths of this interest, which amounted to $40,000 and would otherwise be payable December 1, 1940. The $40,000 was paid in

three installments, as follows: $10,000 on December 2, 1940, $10,000 on March 27, 1941, and $20,000 on September 15, 1941. (R. 9–10, 14, 78.)

In its return for the fiscal year ending September 30, 1940, taxpayer deducted the $40,000 as interest accrued for that year. The Commissioner disallowed the deduction on the ground that it did not represent interest within the meaning of Section 23 (b) of the Internal Revenue Code, resulting in deficiencies in taxpayer's income and declared value excess profits tax in the amounts of $6,940.15 and $2,415.73, respectively. (R. 10, 59, 73.) The Tax Court sustained the Commissioner's determination (R. 85), and the Circuit Court of Appeals affirmed (R. 104).

ARGUMENT

There is no occasion for further review. The decision below is in harmony with decisions of this Court and no conflict among the circuits exists.

1. "Interest * * * on indebtedness" within the meaning of Section 23 (b) of the Internal Revenue Code, *supra*, p. 2, does not embrace amounts payable upon a contingency. *Equitable Society* v. *Commissioner*, 321 U. S. 560. The fundamental difference between deductible interest and a non-deductible dividend is that the former is payable absolutely, irrespective of whether the taxpayer has earnings, while the latter is dependent upon earnings. The cases ac-

cordingly uniformly hold that whether so-called interest is "in reality" a dividend (Section 19.23 (b)-1 of Treasury Regulations 103, *supra*, p. 3), turns primarily upon this distinguishing feature. See *Commissioner* v. *John Kelley Co.*, 146 F. 2d 466 (C. C. A. 7th), petition for certiorari pending, No. 948, present Term; *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182, 185 (C. C. A. 7th); *Commissioner* v. *H. P. Hood & Sons*, 141 F. 2d 467 (C. C. A. 1st). The courts below correctly held that the deduction here claimed did not qualify as "interest" because taxpayer did not contract to pay a fixed rate irrespective of earnings, but a variable rate contingent upon the amount of its annual net earnings.[1]

2. The decision below is clearly in accord with *Commissioner* v. *O. P. P. Holding Corp.*, 76 F. 2d 11 (C. C. A. 2d), upon which taxpayer relies as creating a conflict (Pet. 4, 12–13). The court there stressed the very criterion which the court below emphasized. It pointed out (76 F. 2d at

[1] Nor did the claimed deduction constitute interest on "indebtedness," since it did not represent an amount which taxpayer contracted to pay "for the use of borrowed money." *Deputy* v. *du Pont*, 308 U. S. 488, 497–498. The so-called notes which taxpayer substituted for a portion of its outstanding capital stock were merely new evidences of risk capital. Cf. *Staked Plains Trust* v. *Commissioner*, 143 F. 2d 421 (C. C. A. 5th). Moreover, as the court below noted (R. 99–100), the "notes" bore many of the characteristics of preferred stock.

p. 12) that the taxpayer was obligated to pay a fixed rate of interest "regardless" of whether it had earnings, that "This distinction marks the vital difference between the shareholder and the creditor," and that the numerous decisions in this field "may be harmonized by adopting the criterion above suggested." Taxpayer's assertion (Pet. 5, 23–27) that the instant case presents an important issue rests on the assumption that the controlling principles are unsettled. While each case necessarily turns on its own facts, the applicable legal standards are established and there is no conflict among the circuits.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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